Market Bulletin

May 13, 2016

1Q16 earnings update: Beating estimates, but not yet growing

In brief

- Following the 2015 decline, S&P 500 earnings per share (EPS) fell -6.7% in the first quarter.[1] Companies beat earnings estimates but missed revenue estimates.
- We maintain our view that the headwinds weighing on aggregate earnings—energy prices and a stronger dollar—will dissipate over the course of 2016, leading to mildly positive earnings growth for the year. However, we are keeping an eye on rising wages, which have the potential to press on earnings and margins just as other headwinds subside.
- When it comes to choosing the best metric for evaluating earnings, we prefer operating earnings, as they offer the cleanest view into a company's day-to-day business.
- If the gradual earnings recovery that we anticipate occurs during the second half of 2016, we see some upside for U.S. equities.

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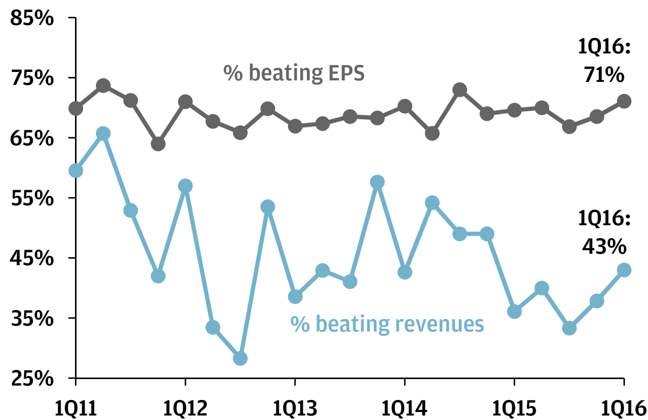
To beat, or not to beat

The past year has been characterized by a decline in corporate profits, for reasons that are fairly well understood—a stronger U.S. dollar and lower energy prices. We expect these headwinds will finally abate and earnings growth will turn positive in the second half of the year. This earnings season, analysts' earnings estimates were too low, but their revenue estimates remain too high (**Exhibit 1**, next page). A lot of this seems to be the result of managed expectations: When you put the bar on the floor, it becomes very easy to step over it. However, a company beating earnings estimates is very different from a company growing earnings.

[1] Figures in this bulletin are based on the S&P 500 Index, are on a quarterly basis and growth rates are year-over-year (y/y) comparisons, unless stated otherwise.

Low expectations: Since late-2014, about 70% of S&P 500 companies have been beating earnings estimates; revenues have been more mixed

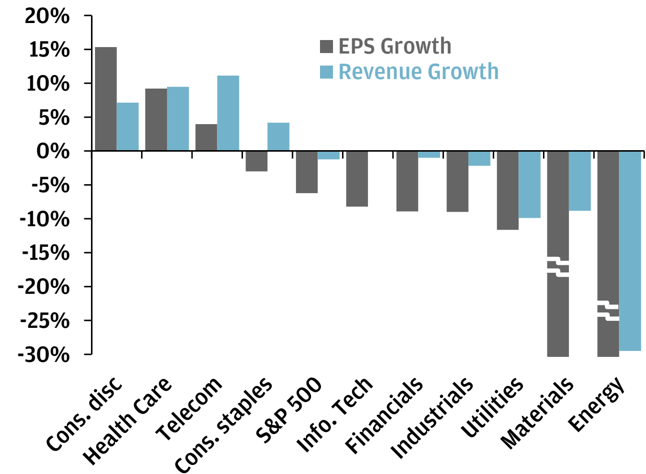
EXHIBIT 1: % OF COMPANIES BEATING REVENUE & EPS ESTIMATES
S&P 500 COMPANIES, QUARTERLY, OPERATING EARNINGS



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management; data are as of May 13, 2016. For illustrative purposes only.

Weak global growth: Materials and energy continued to struggle; consumer discretionary was a bright spot

EXHIBIT 2: YEAR-OVER-YEAR REVENUE AND EPS GROWTH
QUARTERLY, OPERATING EARNINGS



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management, materials and energy y/y EPS growth of -48% and -658%; data are as of May 13, 2016. For illustrative purposes only.

Revenue estimates are still too high, though top line growth showed some improvement in Q1, with 43% of companies beating revenue estimates. This was largely FX driven, as the U.S. dollar's 4.2% decline relative to its major trading partners brought some relief—the first lift to international sales figures in over a year. However, there is a lag before currency depreciation helps revenues; it will take some time before companies see the full benefit.

Despite the currency lift, a backdrop of weak global growth has weighed on the top line for many sectors. This dynamic, combined with a very volatile quarter for commodity prices, has led to a continuing struggle for the energy, materials and industrial sectors (**Exhibit 2**). Profits in the financial sector were not as bad as many feared, but remain down year-over-year. The technology sector disappointed in aggregate, a function of weaker than expected earnings at some larger companies. Consumer discretionary posted the strongest year-over-year earnings growth, and health care grew revenues by nearly 10%.

The first quarter may not mark the bottom of the current earnings recession, yet we are cautiously optimistic the worst may be behind us. Risks remain: a renewed bout of U.S. dollar strength on the back of a hawkish Federal Reserve (Fed) or a slowdown in China could both put downward pressure on commodity prices. However, with two rate hikes this year looking increasingly unlikely, we doubt significant dollar strength will emerge anytime soon. Assuming that the dollar does not meaningfully strengthen and wage growth does not meaningfully accelerate, aggregate earnings growth should turn mildly positive in the second half of the year.

Mind the GAAP

Investors may be asking themselves how they will know when earnings growth has turned positive, as earnings can be looked at in three ways: generally accepted accounting principles (GAAP); operating earnings, which add back restructuring charges; and pro forma earnings, which add back a number of different items to highlight earnings generated from continuing operations and show the company's ongoing earnings power. **Exhibit 3** highlights some differences between the measures. Each measure has its merits. They are drawing attention now because in the past few quarters, the gap between them has grown, spurring debate over which is preferable, and what the growing spread might signal.

Divergent accounting: Using pro forma earnings provides a lift, but we prefer operating earnings

EXHIBIT 3: DIFFERENCES BETWEEN GAAP, OPERATING & PRO FORMA EARNINGS CALCULATIONS

	4Q15 S&P 500 earnings per share
Pro forma operating earnings	$118
Examples of items added back: gains/losses on asset sales, asset/goodwill impairments, M&A costs, non-cash compensation, amortization of pension gains/losses	↑ $14
S&P operating earnings	$104
Add back: restructuring charges related to acquisitions, sales & discontinued operations	↑ $13
GAAP/reported earnings	$91

Source: J.P. Morgan Asset Management, 4Q15 estimate. Trailing 4-quarters shown above; data are as of May 13, 2016. For illustrative purposes only.

We prefer looking at operating earnings to measure corporate profits and formulate our view on where equities are headed. We understand the thinking behind some, but not all, of the pro forma adjustments. Originally, pro forma earnings excluded one-time or non-recurring charges (restructuring and goodwill amortization). More recently, pro forma earnings have come to exclude more: stock-based compensation, intangible asset amortization and charges related to weakness in the commodity space. While it seems fair to exclude impairments and write-downs stemming from the sharp decline in energy prices, the other adjustments seem less reasonable (see sidebar, *A deeper dive into pro forma*). Pro forma adjustments can make it more difficult to compare current earnings to prior periods.

It is true that write-downs stemming from weak commodity prices can be viewed as non-recurring items, but when companies write down an asset, unfortunately, they cannot "write up" the asset later. This would not be viewed as an issue if the write-down is not directly related to revenues generated from the asset (i.e., the price of oil). However, since we anticipate oil prices will eventually rebound and these companies will return to profitability, these write-downs lead to a smaller asset base and inflated profitability metrics, such as return on equity, down the road. While this is by no means an issue at the moment, we would recommend more scrutiny regarding these ratios in future quarters.

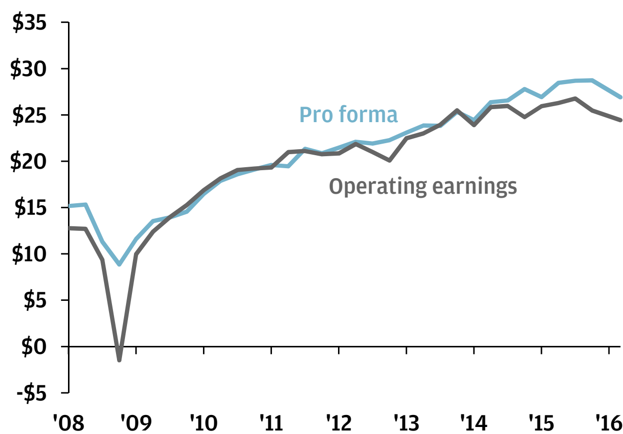
What explains the growing gap between earnings measures? Stock-based compensation and amortization are only partially responsible. According to Morgan Stanley Research, approximately half of the earnings adjustments made last year were due to truly non-recurring issues, such as asset impairments or discontinued operations, particularly in the energy sector.[2] When the energy sector is excluded, the gap between pro forma and operating earnings shrinks, as shown in **Exhibit 4**. We think it makes the most sense to look at operating earnings when evaluating corporate profits. Doing so reduces the risk of inappropriate qualitative judgments and allows for apples-to-apples comparisons in the future.

[2] Parker, Adam S. "N. America Insight: The GAAP Gap – Does It Matter?" Morgan Stanley U.S. Equity Strategy. April 20, 2016.

This reinforces the idea that—excluding energy—the divergence is not signaling a change in the likely direction of earnings. The underlying trend we anticipate for earnings (under pressure for the first half with recovery anticipated in the second half) remains intact.

What gap? The spread between pro forma and operating earnings shrinks, when energy is excluded

EXHIBIT 4: EARNINGS PER SHARE EX-ENERGY
QUARTERLY, PRO FORMA AND OPERATING EARNINGS



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management; data are as of May 13, 2016. For illustrative purposes only.

Productivity, profitability & wages

We expect earnings should recover during the remainder of 2016 as headwinds from a stronger U.S. dollar and lower energy prices gradually subside. While it appears these developments are underway, another risk has popped up on our radar—wage growth.

The 4Q15 corporate profit numbers showed signs of upward pressure on wages, and the most recent employment report saw wages accelerate to an annual growth rate of 2.5%. This is still well below the 50-year average growth rate of 4.3%, but as **Exhibit 5** shows, corporate compensation as a percentage of corporate GDP (the labor share of income) has begun to rise.

Early in the cycle, companies have the upper hand when it comes to wages, as employees are content simply to be employed. By keeping wage costs low, companies can boost margins and generate healthy profit growth, which in turn gives them the resources to increase hiring and capital spending.

A DEEPER DIVE INTO PRO FORMA

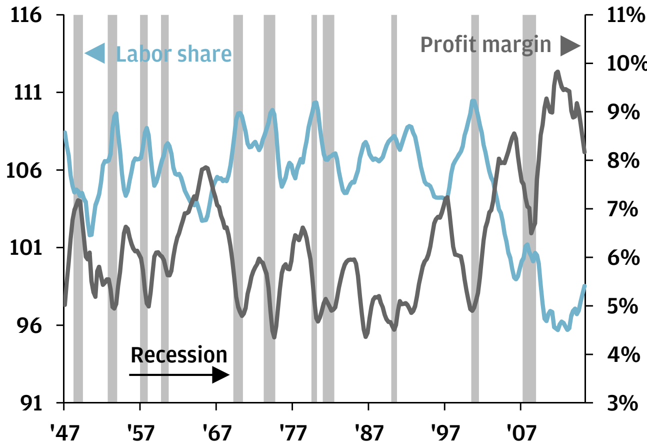
Many analysts believe that excluding stock-based compensation, particularly options, makes sense when calculating pro forma earnings, as granting stock options is a non-cash expense. Although issuing stock options to employees does not involve cash, it does involve an opportunity cost. When a company grants its employees options, it is giving up the cash it could have generated if it had sold these options to underwriters, who could subsequently sell these options to investors. As a result, excluding stock-based compensation seems inappropriate.

Turning to amortization of intangible assets, traditional accounting rules dictate that intangibles with a finite life (such as licenses, agreements, patents) should be expensed over their useful life. Think about the amortization of an intangible asset as the cost required to maintain the revenue that the asset generates. Some analysts believe this amortization should be added back in the calculation of pro forma earnings; however, this ignores the economic cost of maintaining the asset. Furthermore, including the amortization expense makes it easier to compare a company that has acquired an asset with a company that developed a similar asset internally and incurred a "cash" cost.

Profits under pressure: Historically, a rise in compensation's share of GDP has signaled a maturing business cycle and a potential margin squeeze

EXHIBIT 6: LABOR SHARE OF INCOME AND PROFIT MARGINS

3-MONTH MOVING AVG., NIPA CORPORATE PROFIT MARGINS, INDEX OF LABOR SHARE OF NON-FINANCIAL CORPORATIONS



Source: Federal Reserve Bank of St. Louis, NBER, J.P. Morgan Asset Management; data are as of May 13, 2016. For illustrative purposes only.

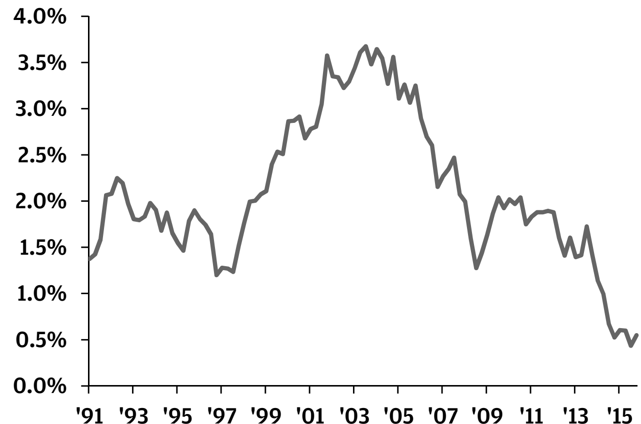
However, as the cycle matures, output growth becomes dependent on a business's ability to pay both labor and capital. In other words, as labor markets tighten, employees can command higher wages, pressuring margins. This tends to coincide with the maturation of the business cycle, and as margins come under pressure, companies need to invest in themselves for output growth to continue. The easiest way to grow output is to boost productivity, as this makes the pie bigger, and there is a close historical relationship between capital expenditures and productivity growth. However, both productivity and capital spending have been relatively muted since the financial crisis, suggesting relief may not be on companies' immediate horizons.

We expect a gradual acceleration in wage growth over the course of 2016. However, if wages are rising without a commensurate increase in productivity, the only way this less productive workforce can increase its output is by working more hours. Combining an increase in wages and an increase in hours worked is bad for profits. As headwinds from energy and the dollar begin to subside, will wages remain in check long enough for earnings growth to recover from the energy and dollar-induced malaise? If not, will productivity save the day and surprise to the upside? The risk is that productivity remains muted and wages begin to rise, putting downward pressure on corporate profits. This dynamic should be on every investor's radar.

Muted productivity: A less-productive workforce plus higher wages and longer hours bode ill for profits

EXHIBIT 6: LABOR SHARE OF INCOME AND PROFIT MARGINS

5-YR. MOVING AVG., OUTPUT PER HOUR, NONFARM BUSINESS, SAAR



Source: BLS, FactSet, J.P. Morgan Asset Management; data are as of May 13, 2016. For illustrative purposes only.

Investment implications

We believe earnings growth is in the process of bottoming and should gradually recover over the remainder of this year. Headwinds from lower energy prices and a stronger currency are beginning to fade, but the weak global economic backdrop continues to weigh on operating leverage for many corporations. Margins don't look set to collapse as long as the economy stays out of recession, but we are seeing signs of accelerating wage growth at a time when productivity growth is stuck in a rut. This risk for the corporate sector bears watching, but does not necessarily signal the end of the current cycle. Furthermore, if our thesis of a gradual earnings recovery is correct, we see some upside for U.S. equities from current levels. However, earnings growth is key. It seems unlikely higher levels will be achieved on the back of multiple expansion.

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